The Installment Plan and the Baby Bond

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THERE is in financial literature a surplus of articles intended to reinforce the assumedly feeble will of the average American to save. The intention is not to add here another contribution to the voluminous literature designed to induce thrift but rather to describe some features of finance which have contributed in recent years to make investment easy, safe and profitable for the small investor. It must also be pointed out that these features, with all their attendant individual and community benefits, are subject like other human institutions to misuse.

Agencies of Thrift in the United States

Arranged approximately in the order of their general use by the majority of the people, the agencies of thrift in the United States are (1) Savings banks, (2) Insurance, (3) Building-and-loan associations and (4) Security investments. For the past ten years considerable effort has been devoted to making the latter agency more readily available to the average person, culminating in the campaigns for the popular subscription of war funds. To make this agency for thrift effective among the greater portion of the population it is necessary to harmonize security investments with the means of the small investor, a necessity which may be met by either or both of the following methods:

(1) Enable the investor to pay for the investment unit, stock or bond, on the installment plan. This is adapting the investor's purchasing power to the commodity to be purchased.

(2) Reduce the size of the investment unit, making it possible to purchase a share for $25 instead of $100 or a bond for $100 instead of $1,000. This is adapting the commodity to the investor's purchasing power.

Adapting Purchasing Power to the Commodity

The Installment Plan.—The partial-payment plan is not new in the sense that it is a radical departure from previous methods of doing business. Fundamentally, it is, like a margin purchase, the buying of securities by a customer, partly on borrowed money and partly on his own capital, the purchased securities serving as collateral for the funds borrowed. This transaction is, however, modified (a) by encouraging purchases by small investors and (b) by reducing to a minimum the highly speculative possibilities.

Odd-Lot Dealers.—Purchases by small investors involve odd lots,[1] and a few words are required to describe their significance, it being understood that odd lots may be bought outright and do not necessarily involve the partial-payment plan. Nor do partial payments preclude the buying of round lots, though this is rare. The odd-lot business is a specialty engaged in on

[1] Lots of less than 100 shares, which is the unit of trading on nearly all stock exchanges.

a large scale by relatively few concerns, although nearly all brokers occasionally handle small amounts. It is made possible by the existence of the odd-lot *dealer*,[2] who, as distinguished from a broker, derives his profit from the difference between the buying and selling prices of the securities he handles. He buys or sells odd lots and reverses these transactions in round lots by either combining the odd lots bought into a round lot or splitting up round lots purchased to deliver on his odd-lot sales. Such dealers are not numerous, five or six important firms being found in the membership of the New York Stock Exchange. Each firm, however, often has several partners owning Exchange seats and one firm controls eleven.

Odd-Lot Brokers.—The larger part of the odd-lot dealer's business is brought to him by odd-lot *brokers*. These do not differ from the ordinary commission broker, except that they are willing to buy or sell odd lots for customers, whereas with the ordinary broker this is more or less an accommodation. The odd-lot broker, however, not only accepts but even advertises for this class of business. The remuneration of the broker is a commission charged the customer, varying with the price of the securities.[3] There are possibly sixty-five members of the New York Stock Exchange engaged to any extent in the odd-lot business. Of this number it is said that only three or four at most operate partial-payment plans, although the plan is extensively advertised by firms outside the exchange.

[2] In the United States the same individuals may operate in both capacities but in England these functions are sharply separated.

[3] See page 172

One of the largest of the exchange firms carries on its books many thousands of odd-lot and partial-payment accounts.

USUAL OPERATION OF THE PARTIAL-PAYMENT PLAN

Character of Securities Bought.—With its place in finance, its scope and accompanying features in mind we pass to an examination of the usual operation of the partial-payment plan, with some comments on the variations introduced. The plan in its most desirable form presupposes that only high-grade investment securities are to be bought; otherwise those who can least afford to lose are encouraged to speculate. One firm tries to effect this by compiling a list of approximately ninety securities which may be purchased, with exceptions only for good reasons but with modifications as found necessary. Some other firms exercise little or no supervision over this matter. Even high-grade securities, if inactive, are not desirable from the broker's viewpoint, because of the impossibility of using the odd-lot certificates as collateral for bank loans.

Initial Deposits.—To purchase an odd lot on the partial-payment plan the customer makes an initial deposit of a portion of the purchase price. The following is typical of the initial deposits required:

On bonds	
$100 denomination	$10 a bond
500 "	50 " "
1000 "	100 " "
On stocks selling	
Below 30	$10 a share
From 30 to 50	15 " "
From 50 to 100	20 " "
From 100 to 150	30 " "
From 150 to 200	50 " "
Above 200	Special terms

A purchase of eight shares at $90 per share would require a deposit, therefore, of $160. A variation is to require a straight 20 per cent of the purchase price, which will average lower than the preceding scale. Curb houses sometimes provide for low-priced stock by a scale of deposits ranging from one dollar per share up. The balance of the purchase price is advanced by the broker, who has the certificate transferred to his name and borrows on it from a bank. On the eight shares at $90 in our hypothetical case he would probably be able to borrow a little over $600.

Monthly Payments.—The theory is that the customer will now pay for the stock in installments, making agreed-upon payments on the first of each month of at least $5 on each $100 bond bought, $3 on each share of stock at less than $30 and $5 on each share at $30 or over. In our hypothetical case the customer would agree to pay $40 a month. In some cases the balance due is divided into twenty equal payments or 10 equal payments and the plan called a "twenty-payment plan" or "ten-payment plan." It will be noticed that with each monthly payment the customer's debt to the broker is decreased and his equity in the stock correspondingly increased. When fully paid for the shares are transferred to his name on the corporate books and forwarded to him. In the meantime he is credited with all interest or dividends paid on the securities bought and charged interest on the net balance he owes. This interest is usually at the rate money costs the broker but at least 6 per cent. Since call loan rates in ordinary times seldom exceed 6 per cent this is usually the rate charged. Since our hypothetical customer is paying 6 per cent on the $560 owed (eliminating commissions for the present) and is receiving the dividends on the par value ($800) it is usually true that his money is earning interest for him while he is paying for the securities. One concern states that it absorbs the interest charge in its commission which is, of course, much above the usual rate.

Disposal of Accounts when Payments Lapse.—A very natural question is, what happens to an account on which the payments lapse? This may be treated in either of two ways. In the first place it may thereafter be considered as an ordinary margin account, provided the amount of the customer's deposit warrants it; if not, additional margin is called for and if not supplied the securities are sold. Secondly, it may be specially treated, as was the case with one firm, by being transferred into a special class of accounts on which a penalty is imposed in the form of an additional carrying charge of say 2 per cent a year. One large house employing this latter plan has recently abolished it.

Freedom of the Customer.—The customer may increase his payments at any time, may pay in full at any time and receive his securities, or if he decides to abandon the plan may sell at any time. It is the essence of the plan, however, that it is for investment purposes and is not to be employed to constantly speculate on market prices by conducting an active trading account. Some houses therefore will not handle an account which is obviously purely a small margin-trading account. In other respects the partial-payment plan resembles ordinary security transactions.

Calls for Additional Margin.—One other feature deserves special mention. The amount the customer has on deposit with the broker is termed his margin. Prior to 1913 some houses, with no unfortunate results and with the excellent intention of further divesting the partial-payment plan of margin-purchase characteristics, guaranteed the customer under all circumstances against any call for margin over and above his regular monthly payment. Under a properly conducted plan this can be accomplished with perfect safety. In 1913, however, a resolution adopted by the Governing Committee of the New York Stock Exchange prohibited the carrying of accounts without proper and adequate margin[4], and this guarantee was considered as violating the spirit of the resolution and consequently abandoned by Stock Exchange houses. Curb brokers likewise appear to refrain now from giving this guarantee. How such a guarantee can be given on securities which fluctuate widely and rapidly in price one can only speculate.

Broker's Commissions.—The broker receives for his services (1) a commission of at least \$1.50,[5] (2) the use of the capital supplied by the difference between the amount the broker lends the customer and the amount the broker borrows from the bank and (3) any excess of interest charged the customer by the broker above what he pays for money borrowed. It should also be stated that odd-lot orders are usually executed at a slight concession, buying orders at one-eighth above and selling orders at one-eighth under the current market quotation.

Benefits of the Partial-Payment Plan

From the standpoint of the individual the partial-payment plan has many advantages, among which are the following:

Small-Scale Investment.—It enables small investors to purchase high-grade securities with a small immediate expenditure of capital. This counteracts to some degree the usually unfortunate tendency of small buyers to purchase several shares of a cheap stock in preference to one share in a relatively conservative business. It also enables the small purchaser to invest his surplus as received and without delay. It provides a legitimate substitute for the so-called "bucket-shop."

Reinforced Will-Power.—The assumption of an obligation to make payments at regular intervals and the desire to own the security free of all encumbrance supply inducements to

[4] Resolution of the Governing Committee, New York Stock Exchange, February 13, 1913. Constitution of the New York Stock Exchange, with amendments to January, 1918, p. 99.

[5] The New York Stock Exchange and the New York Curb Association have prescribed commission rates, as follows:

New York Stock Exchange

Bonds ⅛ of 1% of par value

Stocks	
Selling below \$10	7.5¢ per share
" \$10 to \$125	15.0¢ " "
" \$125 or over	20.0¢ " "

Minimum commission, \$1.00

New York Curb Association

Stocks	
Selling below \$1	2% of total amount involved
" \$1–3	4¢ per share
" \$3–5	5½¢ " "
" \$5–10	7½¢ " "
\$10–125	15¢ " "
over \$125	20¢ " "

Minimum \$1.00

save. Each monthly payment increases the customer's equity and consequently his returns.

An Open Bargain Counter.—It gives the opportunity to purchase securities at a favorable price, while if immediate full payment were required the opportunity would be lost.

Investment Insurance.—It enables the small investor to practice distribution of risk, an advantage otherwise available only to the person of means. Carnegie's advice to put all the eggs in one basket and watch the basket is inapplicable to the average person because he is not sure which basket to put them in and because he has neither the ability nor time properly to watch the basket. The other alternative is to distribute investments so that the loss upon any one will be small compared with the total investment. Such a distribution may be made geographically, avoiding the large loss otherwise consequent upon the adverse business conditions of a particular community; industrially, avoiding the large loss consequent upon a depression in some few lines of business or on the basis of hazard, distributing purchases between bonds and stock or conservative and speculative enterprises.

InvestmentService.—Reputable houses furnish the investor with an investment service, advising him as to the character of his investments, furnishing financial facts and suggesting combinations fitted to his needs. This is easily subject to abuse.

Investment Balance-Wheel.—The system operates to induce conservative trading, because, while in a margin transaction the customer may assume large obligations without foresight, under the partial-payment plan the size of the periodical payment required will reasonably restrict his actions.

Increasing Income.—The plan has the advantage over other systems involving borrowing that the purchaser's equity in the securities is increasing and his debt and carrying charges consequently decreasing, resulting in a constantly increasing income reaching its maximum when the securities are paid for in full.

From the standpoint of the community the plan also has advantages.

Thrift.—It is universally acknowledged that thrift is a national asset, involving the conservation of resources and the accumulation of capital, and the benefit of the instinct developed by the partial-payment plan will be realized in many other directions.

Provision for the Future.—It enables the accumulation of funds for the support of the individual and his dependents after earning power has diminished or ceased, a burden which would otherwise fall on the community.

Manipulation.—It tends to create a wide distribution of the ownership of corporate securities, with consequently smaller opportunities for manipulation of prices.

Extension of the Capital Field.—It extends the field of potential capital by making everyone a prospective investor and capitalist to some degree, consequently widening the field for raising capital when necessary.

Community of Interest.—It enables the general public to share in the munificent returns supposed to be earned by large corporations and to the degree to which this opportunity is taken advantage of, it promotes a community of interest between "big business" and the general public.

ABUSES OF THE PARTIAL-PAYMENT PLAN

But the more economically sound a plan is and the greater the need it satisfies, the more attractive a cloak it becomes under which to conceal activities entirely foreign to its purpose. So it is with the partial-payment plan. Great as are its possibilities, equally great are its possible abuses. One of the chief purposes of this paper is to show how deceitfully and destructively it may be misused.

(1) *It may be employed by an insecure business merely for the purpose of obtaining additional capital.*—It will be remembered that the customer's equity in the securities is growing with each payment made. Until the shares are transferred to his name this equity is assuming more and more the nature of a trust fund, though it is hard to draw the line of demarcation. The original margin is necessary for the broker's protection in the event of a decline in the price of the securities before any further payments are made. But it is plain that as the customer continues his monthly payments the amount on deposit gradually, and in time greatly, exceeds the amount necessary for the protection of the broker. To the extent that this is true the fund becomes the equivalent of a deposit in a savings bank or a payment in a building-and-loan association. And yet, strange as it may appear, it has thrown about it none of the protection afforded bank deposits or building-and-loan funds. The broker may use it as he pleases, provided only that he be ready to deliver the securities upon payment of the balance due by the customer. If he cannot do this he is usually insolvent and the customer must take his chances among the creditors. Under such circumstances the character of the house with which the customer is dealing becomes of inestimable importance. Yet there is nothing to prevent any broker from starting a partial-payment plan.

(2) *When dealing with unreliable firms the customer may not get the benefit of the correct price.*—There may be a variation of perhaps a point between the high and low prices of the day, and it is reputed that customers are often charged the high price of the day when in fact their orders were actually executed at much lower figures. This, of course, is not peculiar to the partial-payment purchase; but in view of the care required to obtain any profit from this class of business it offers a peculiar temptation to illegitimate practices.

(3) *The unreliable firm may not buy the stock at all—"bucket" the order.*—Since the customer never sees the security until fully paid for, which is not usually for at least a year, the broker may notify the customer that the purchase has been made at a definite figure and then gamble on future prices, hoping to be able to buy it for much less. His anticipations may be realized, in which case the customer has been defrauded by his own hired and paid agent; or they may not, whereupon if many others have been treated in the same manner an insolvency ensues.

(4) *The broker may disappear with the funds in his possession.*—This danger is not peculiar to the partial-payment plan, but is augmented by the character of the plan. From

ordinary margin buyers the broker can never embezzle more than 10 or 20 per cent of the purchase price, whereas from the partial-payment buyers there is a constant influx of funds and a continual increase in the amount of other persons' property held by him. It might be expected, therefore, that an illegitimate enterprise would find the partial-payment plan a ready means of making ten or fifteen blades of grass grow where but one grew before.

(5) *The plan may also be used to entice persons to speculate recklessly who otherwise would abstain.*—Persons who abhor "buying on margin" will readily consent to enter into a partial-payment plan for conservative investment. Later it is easy to inveigle them into highly speculative purchases, to convince them that the partial-payment plan and margin buying are identical after all, and both harmless, and, finally, to have them buying and selling with tolerable frequency nearly any security. An active account, with frequent transactions, yields far more in the way of commissions than a partial-payment account which, at best, offers the hope of only an exceedingly small return.

(6) *Speculative Character of Accounts.*—Even where the broker is indifferent or opposed to the result described above, the account frequently assumes a speculative character without incitement and despite opposition. The customer himself never intends to buy and pay for the securities ordered, but merely regards the partial-payment plan as an opportunity for doing on a small scale what his means will not permit by the ordinary method. For the success of the plan, not only the broker but also the customer must be sincere. For the broker closely to watch the state of mind of his many small customers as evidenced by their actions is too much to expect and this explains why firms which have exerted every effort conscientiously to administer the plan have not been entirely satisfied with the results.

The odd-lot business of brokers has apparently not yielded any large profit thus far because of the expense of the tremendous amount of clerical work involved and the disproportion of postage and miscellaneous expense to the commission earned. The recent tendency has been to increase the obligations of the customer. One large house has very recently proceeded to do this by the following requirements, the objects of which are self-evident:

(1) Acceptance of no partial-payment accounts carrying less than five shares of stock or $500 par value of bonds.

(2) A minimum carrying charge sufficient to yield at least $2 per account per month, including commissions.

(3) A usual transfer charge of 4 cents per share.

ADAPTING THE COMMODITY TO PURCHASING POWER

The second method suggested, of adapting the commodity to the investor's purchasing power by decreasing the size of the investment unit, is equally important but requires little description. This method was adopted in conjunction with the partial-payment plan in the sale of Liberty bonds and proved eminently successful. For years prior to this, however, the so-

called "baby bond" was being put on the market, and within recent years hundreds of such issues are available to the small investor. Lists of prominent bonds of $50 and $100 denominations are frequently published in the columns of magazines and space is not available here to reproduce such a list. One New York firm, at least, is now more or less specializing in the sale of bonds of small denominations directly to the public, eliminating the middleman's profit. Thus far there has been practically no deliberate application of this method to stock certificates, although it would supply all of the benefits of the partial-payment plan with very few of the abuses to which that plan is subject. To place commodities such as pianos and automobiles in the hands of persons of limited means, the partial-payment plan is essential, since these articles cannot be divided, but corporate capital is easily divisible and its adaptation to purchasing power consequently convenient. There is no reason, apparently, why $10, $25 and $50 should not become standard par values for stock certificates instead of $100.

It will easily be seen by retrospection that the baby bond idea has all the advantages of the partial-payment plan—encouragement of thrift, diversification of investments, restriction of speculation, provision for the future, diminution of manipulation, extension of the capital field and community of interest. It has worked satisfactorily in the case of bonds and it is curious that it has not been applied extensively to stock certificates, where the results would be even greater. One might anticipate that with a reduction of the par value to $10 per share the interest in the Pennsylvania Railroad Company would be increased from 100,000 to 200,000 or 300,000 persons and that similar results would obtain in other large corporations. This is a possibility worthy of serious consideration by promoters and underwriters. A reduction in the par value of shares would produce all the benefits of the partial-payment plan and eliminate some of the abuses of this system. It would broaden the investment field in the United States and open up new fields for stocks and bonds of American corporations in foreign countries, where large denominations have always been a detriment to wide distribution.